CYNGOR SIR *POWYS* COUNTY COUNCIL

Pensions and Investment Committee
11th February 2016

REPORT BY: **Strategic Director of Resources**

SUBJECT: **Proposals for Reform of LGPS Investment**

REPORT FOR: **Information**

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1 Introduction

1.1 On 25th November DCLG issued consultation documents that set out proposals for the reform of LGPS investment regulations and requests responses from LGPS Funds and other stakeholders by 19th February. This paper outlines the principal proposals and includes a response from the Pension Fund to the consultation approved by the Section 151 Officer in consultation with the Chair and Vice Chair of Committee.

2 Background

2.1 The draft regulations propose to revoke and replace the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 with effect from 1st April 2016. The new regulations will be made under Sections 1 and 3, and Schedule 3, of the Public Service Pensions Act 2013.

3 Principal Reforms

3.1 The proposed regulations are intended to provide a simple framework for LGPS Funds under which they can invest and manage pension fund assets, with greater responsibility being placed on each administering authority. The changes, by simplifying the 2009 regulations and removing the Schedule 1 benchmarks, moves to the 'prudent person principle' which applies in the private sector. Accordingly, administering authorities will be required to take full responsibility to determine appropriately diversified investment strategies that take risk into account.

3.2 The 2009 requirement to prepare and publish a Statement of Investment Principles is to be replaced by a requirement to publish an Investment Strategy Statement. Administering authorities will be required to include in their strategies the regulatory essentials previously contained in the 2009 provisions, including the need for diversification; the suitability and types of investments; the administering authority's approach to risk, including its management and measurement; the administering authority's approach to collaboration, collective investment vehicles and shared services; its policy on environmental, social and corporate governance matters; and its policy on rights and voting rights.

3.3 Transitional arrangements are proposed with a six month period within which new statements must be introduced (likely to be by 30th September 2016). Current SIPs will apply until replaced.

3.4 The draft regulations also propose new powers for the Secretary of State to issue directions to an administering authority if the Secretary of State is satisfied that the administering authority is failing to have regard to the regulations and the relevant guidance. If justified, the Secretary of State can direct the administering authority to undertake a range of actions to ensure compliance with the Government's priorities for LGPS Funds to take advantage of the benefits of scale it believes are available from asset pooling.

3.5 Accompanying the draft regulations, DCLG guidance provides administering authorities with the criteria that they are expected to apply in their pooling arrangements, while maintaining overall investment performance.

3.6 Ministers see the outcome of these proposals as a number of so-called British Wealth Funds (possibly 6 or so), each with approximately £25bn of assets with the objective that administering authorities will develop the capacity and capability to become leaders in infrastructure investment to help drive growth.

4. Principal Considerations

4.1 The revocation of the 2009 regulations and their replacement are significant. The powers in the 2013 Act are seen as appropriate for the changes proposed. However, the 2016 proposals retain many elements of the 2009 regulations but places them into the fund specific investment strategy statements, including diversification, advice, risk assessment and publication. The definition of 'investment' is simplified and Schedule 1 (Table of Limits on Investments) of the 2009 regulations is consequently discarded. The removal of these limits has been deemed necessary as they are seen as limiting investment activity. The responsibility for prudence and diversification is now placed directly and in full, to each individual administering authority to consider and detail as an intrinsic part of their individual strategies. This raises a number of potential risks such as multiple compliance, variable assessment, greater inter-fund variability and overall effectiveness.

4.2 The proposal to give powers of intervention at individual fund level to the Secretary of State is both contentious and radical. The Government appears to be seeking to impel LGPS Funds into new structures, with potentially much weaker local governance, to further national policies for infrastructure projects, linked to wider growth objectives for the economy.

4.3 There are no specific references in the proposals to an Infrastructure Commission (as mentioned by the Chancellor in his 5th October party conference speech), although any future role seems inevitably associated with the asset stream being conceived of by these proposed measures.

4.4 Draft regulation 7 requires administering authorities to prepare their strategies in accordance with guidance issued by the Secretary of State. Failure to do so may result in Government taking steps to force the administering authority to comply with the guidance. In essence the full consequence is that the responsibility of each administering authority to administer in detail its local asset portfolio to meet its pension liabilities and, in the context of its valuation cycles, to ensure ongoing affordability and sustainability, is to be removed. This is coupled with the removal of local appointment of investment managers because of the overarching requirement to pool. As the Secretary of State will effectively agree/approve all investment strategies, responsibility for their content will ultimately rest outside of administering authorities. This begs the question that if the Secretary of State directs an administering authority to change its strategy and that change leads to a lower return or a loss, who will have responsibility for the financial outcome?

5. Other Considerations

5.1 Management and Investment of Funds – the new provisions are intended to de-regulate and simplify the 2009 regulations and consultees are asked to consider if the approach is reasonably balanced in its effect. It is generally accepted that the challenges posed by these proposals are likely to place significant pressures on smaller LGPS Funds with limited capacities and capabilities.

5.2 Directions/Pooling/Infrastructure – Draft regulation 7.1 provides the route for the Secretary of State to intervene and become involved directly in the management and investment of LGPS assets. In effect, central government, on the one hand is freeing up the way in which administering authorities are able to manage and invest their assets as part of their stewardship of the national Scheme to meet their statutory pension promise, while on the other, it seeks to direct by means of a threatened intervention process, the pooling of up to £150bn of LGPS assets with untested management and governance arrangements and the associated risks. The guidance material accompanying the consultation makes clear that there is a causal link between the pooled assets and their specific use to fund non local infrastructure projects to further national economic growth policies. This raises certain questions, such as, are infrastructure projects in the best financial interests of pension fund beneficiaries.

6. Questions Asked of Consultees

6.1 The Secretary of State has requested that consultees include in their consultation responses, answers to the following questions:

- 1 - Does the proposed deregulation achieve the intended policy aim of removing any unnecessary regulation while still ensuring that authorities' investments are made prudently and having taken advice?
- 2 - Are there any specific issues that should be reinstated?
- 3 - Is six months the appropriate period for the transitional arrangements to remain in place?
- 4 - Should the regulation be explicit that derivatives should only be used as a risk management tool? Are there any other circumstances in which the use of derivatives would be appropriate?
- 5 - Are there any other sources of evidence that the Secretary of State might draw on to establish whether an intervention is required?
- 6 - Does the intervention allow authorities sufficient scope and time to present evidence in favour of their existing arrangements when either determining an intervention in the first place, or reviewing whether one should remain in place?
- 7 - Does the proposed approach allow the Secretary of State sufficient flexibility to ensure that he is able to introduce a proportionate intervention?
- 8 - Do the proposals meet the objectives of the policy, which are to allow the Secretary of State to make a proportionate intervention in the investment function of an administering authority if it has not had regard to best practice, guidance or regulation?

7. Response

7.1 The following responses to the specific questions raised by the consultation are as follows:

- Whilst the deregulation of investment matters is achievable through the proposed mechanism, there are concerns around the issue of prudence – particularly given that there is no freedom for administering authorities in reality, since failure to adhere to guidance will result in the intervention of the Secretary of State, even where the individual Fund liabilities may require a strategic investment approach that differs from that recommended by the guidance and therefore deemed unsuitable by the Secretary of State.
- Given that the introduction of these changes are proposed to become effective from 1st April 2016, coinciding with a valuation year in England and Wales, it is considered that transitional

arrangements lasting 12 months would aid Funds greatly.
- There seems little need for the regulations to spell out that derivatives should only be used as a risk management tool when the guidance that is proposed to be issued with the regulations will have a statutory authority.
- It is suggested that when the Secretary of State is determining whether or not an intervention is to be undertaken that he/she has due regard to and accepts evidence from, the specialist advisers used by the Fund concerned in making the decision that has given rise to the possible intervention.

7.2 In addition, the Pension Fund's response raises the following matters:

- Is the Government clear about the role of elected members in the pooled fund structure? How can their responsibility be realistic when the continuity prevalent in current structures will be diluted and even broken?
- Will the Government provide assurances to cover infrastructure risk if LGPS assets are directed to fund national infrastructure projects?
- Given that LGPS assets have a specific role within the stewardship of the Scheme locally in matching liabilities, is the Government fully confident that the move to pooled structures will not undermine the Scheme's long-term viability?
- Is widespread LGPS investment in infrastructure projects in the best financial interests of pension beneficiaries – particularly now that national Scheme costs (investment return being a relevant factor) may dictate an increase in members' contribution rates or a reduction in accrual rates, via the cost-management mechanism?
- As the Secretary of State will agree/approve individual fund investment strategies; where a Fund is required by the Secretary of State to make changes and those changes result in a lesser return or a loss, will the Secretary of State be responsible for the financial outcome?
- What scope is there, if any, for a Wealth Fund of significantly less than £25bn in value, such as would result via an all Wales CIV?
- Are there any plans / appetite for LGPS matters to be devolved to Cardiff?

8 Recommendation

8.1 Committee are asked to note the contents of this report.

<table>
<tr><td colspan="2">Recommendation:</td><td>Reason for Recommendation:</td></tr>
<tr><td colspan="2">To note the contents of the report.</td><td>As per report</td></tr>
<tr><td>Person(s) To Action Decision:</td><td colspan="2">Pension Fund Manager</td></tr>
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Date By When Decision To Be Actioned:					
Relevant Policy (ies):	N/A				
Within Policy:	N/A		**Within Budget:**	N/A	
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Relevant Portfolio Member(s):	Councillor Wyn Jones
Relevant Local Member(s):	**N/A**